BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers 3Q '21 Focus List

Top Sells

Company	EQ Rating	Date Added
Altria Group (MO)	3- (Minor Concern)	6/11/2021
Equinix, Inc. (EQIX)	3- (Minor Concern)	4/30/2021
International Business Machines Corporation (IBM)	2- (Weak)	3/12/2021
Iron Mountain Incorporated (IRM)	1- (Strong Concern)	12/4/2020
Keurig Dr Pepper Inc. (KDP)	2- (Weak)	12/4/2020
Mondelez International, Inc. (MDLZ)	2- (Weak)	12/4/2020
Patterson Companies, Inc. (PDCO)	2- (Weak)	9/3/2021
Sysco Corporation (SYY)	3- (Minor Concern)	6/11/2021
Sealed Air Corporation (SEE)	2+ (Weak)	12/4/2020
TransDigm Group Incorporated (TDG)	2+ (Weak)	3/12/2021

On Deck Sells

Company	EQ Rating	Date Added
Ball Corporation (BLL)	3- (Minor Concern)	3/12/2021
Conagra Brands, Inc. (CAG)	2- (Weak)	3/12/2021
Kimberly-Clark Corporation (KMB)	2- (Weak)	9/16/2021
Mohawk Industries, Inc. (MHK)	3- (Minor Concern)	9/16/2021
TreeHouse Foods, Inc. (THS)	3- (Minor Concern)	3/12/2021

Top Buys

Company	EQ Rating	Date Added
Air Lease Corporation (AL)	4+ (Acceptable)	12/4/2021
AT&T Inc.(T)	4+ (Acceptable)	3/12/2021
Mowi ASA (MHGVY)	*4+ (Acceptable)*	12/4/2021
National Instruments Corporation (NATI)	*5+ (Strong)*	3/12/2021
Texas Instruments Incorporated (TXN)	*5+ (Strong)*	3/12/2021
UnitedHealth Group Incorporated (UNH)	*5+ (Strong)*	3/12/2021

Summary of Changes to the 3Q'21 BTN Focus List During the Quarter

Added to Top Sells

Patterson Companies, Inc. (PDCO)	Added 9/3/2021

Removed from Top Sells

Conagra Brands, Inc. (CAG)	Removed 7/14/2021
Patterson Companies, Inc. (PDCO)	Removed 6/25/2021

Added to On Deck Sells

Conagra Brands, Inc. (CAG)	Added 7/14/2021
Kimberly-Clark Corporation (KMB)	Added 9/16/2021
Mohawk Industries, Inc. (MHK)	Added 9/16/2021
Patterson Companies, Inc. (PDCO)	Added 9/3/2021

Removed from "On Deck" Sells

Henry Schein, Inc.	Removed 9/16/2021

Added to Top Buys

LyondellBasell Industries N.V. (LYB)	Added 7/14/2021

Overview of the BTN Focus List

Our foundational belief at Behind the Numbers is that earnings quality matters. We believe that companies that are resorting to increasingly aggressive accounting such as slashing reserves, taking never-ending restructuring charges, or extending depreciable lives to meet earnings estimates will eventually face a day of reckoning in the form of an unexpected earnings disappointment. Likewise, companies with hidden assets, conservative accounting, or non-operational headwinds that will reverse are likely to produce better than anticipated results. This has been borne out time and again by academic research.

While our Earnings Quality ratings express our level of concern with the reliability and sustainability of a company's reported earnings and cash flows, they do not consider more fundamental factors such as valuation, sources of recent revenue growth, upcoming difficult comps, or other factors which might make an idea timelier. The *BTN Focus List* addresses this by documenting which companies under coverage we believe are getting closer to the point of materially underperforming or overperforming.

The list is divided into Top Sells and Buys along with an "On Deck" list of companies we believe have compelling points but may not warrant being on the top lists due to valuation factors. We will continue to publish the Focus List quarterly and will notify clients of the additions and subtraction to the list made during the quarter by e-mail.

Top Sells

Altria Group, Inc (MO)- Top Sell

Date Added	6/11/2021
Market Cap	$89 B
Target Price	$35
PE (fwd)	10.7
Short %	0.6%
Current EQ Rating	3- (Minor Concern)

How the Bulls See It:

MO is seen as a safe staple and a cash cow with a sustainable yield.

Our Concerns:

- We see MO as one of the key beneficiaries of the pandemic as customers who worked from home were free of office smoking bans, train commutes, and airline travel and could therefore smoke more often.
- Last year, customers bought far less gasoline at $25 per barrel oil. Going forward, there will be less disposable income to spend on smoking.
- Smoking remains over 90% of operating income and the dividend consumes 80% of free cash flow – based on our estimate of normalized FCF of about $7.5 billion and the current dividend of $6.6 billion.
- Rising legal ages, graphic packaging mandates, and menthol bans are among the ongoing regulatory hurdles putting pressure on adding new smoking customers.
- MO received a reprieve with the Trump tax cuts in 2017 which added $1 billion in extra cash flow per year. MO spent that on increasing the dividend.
- Free cash flow after the dividend was $1.9 billion in 2020. However, a 500 bps increase in tax rates will cost an extra $500 million in cash and a 5% decline in smoking income will consume another $400 million. 2021 has already had to rebuild working capital for a $2.2 billion hit to free cash YTD. Even viewing the working capital build as one-time, the

loss of more smoking income alone could have the dividend coverage at 100% of FCF very quickly.

Equinix, Inc. (EQIX)- Top Sell

Date Added	4/30/2021
Market Cap	$75 B
Target Price	$450
P/FFO (fwd)	48
Short %	1.2%
Current EQ Rating	3- (Minor Concern)

How the Bulls See It:

EQIX is a liquid play on the demand for data centers offering 8% top-line growth and a small but rapidly growing dividend.

Our Concerns:

- EQIX is not self-funding. It routinely runs a free cash flow deficit of $1.3-$2.0 billion after funding all its growth areas for capital spending and acquisitions. It still has a dividend of $1.0 billion more to pay.
- The company is continually issuing more shares to pay employees, to fund acquisitions, and simply to fund other operations. Organic revenue growth is 8-10% and AFFO growth is 13-16% but these are being boosted by acquisitions and new building. These figures are already being diluted by 400-600 bps from new share issuance to fund the growth. We estimate the dividend is growing 2-3 times the rate of organic growth.
- Finance leases overinflate REIT figures- AFFO would fall by over 5% if the principal portion of leases was not excluded. AFFO figures are also inflated by excluding stock comp and maintenance capex looks light at only 1.1% of PPE.
- Amortizable lives appear long which increases the risk of write-downs.
- Data Centers are a hot investment area now and EQIX is posting growth. We do not see a clear near-term catalyst to cause the stock to drop. However, we believe when the market digests the fact that the company is not self-funding, the degree of dilution it is incurring to fund growth, and that the dividend is far outgrowing the organic growth rate, the stock price could be more than cut in half

International Business Machines Corporation (IBM)- Top Sell

Date Added	3/12/2021
Market Cap	$122 B
Target Price	$90
PE (fwd)	12.8
Short %	2.8%
Current EQ Rating	2- (Weak)

How the Bulls See It:

Bulls believe that after decades of restructuring, IBM has finally found a way to grow profitably. Its 2019 acquisition of Red Hat is expected to help it become a major force in the hybrid cloud space and its upcoming fourth quarter spinoff of the GTS business will provide shareholder value and further focus the business on the cloud.

Our Concerns:

After decades of restructuring, the company's returns are substantially lower. Large, never-ending charges and non-operational benefits erode the quality of reported profit growth.

Evidence of this in the 6/21 quarter included:

- Provision for bad debts swung to a credit of $43 million from a $70 million expense in the 6/20 quarter. This added 10.4 cps to earnings.
- Workforce rebalancing charges fell to $95 million in the 6/21 quarter from $137 million last year adding 3.9 cps to EPS. We continue to believe recent lower workforce rebalancing charges are a result of amounts being included in the $2 billion charges in the 12/20 quarter that was added back to non-GAAP results.
- The company touts cost cutting as adjusted SG&A fell by $43 million. However, the lower bad debt, lower advertising, and lower workforce charges reduced expenses by $119 million and we know travel expense was lower as well. We question if the company is really cutting costs or simply lumped expenses into the huge 12/20 charge.
- Gross margin at GTS improved 110 bp in the 6/21 quarter which added 6.4 cps. This improvement followed 70 bps and 60 bps improvements in the 12/20 and 3/21 quarters, respectively. This follows the company restructuring lower margin contracts in the 12/20 quarter and it appears that the losses associated with this were also lumped into the $2

billion 12/20 quarter charge. The 9/21 quarter will likely benefit but comps become difficult after that. Also, the contract restructuring included adding more services which may lead to higher costs to GTS post spinoff.

- The fact that gross margin fell for the Global Business Systems unit and the Systems unit makes us even more skeptical that the improvement in GTS margins was due to anything but the 12/20 quarter charge.

Iron Mountain Incorporated (IRM)- Top Sell

Date Added	12/4/2021
Market Cap	$13.2 B
Target Price	$18
P/FFO (fwd)	16.4
Short %	9.7%
Current EQ Rating	1- (Strong)

How the Bulls See It:

IRM is seen by bulls as a beneficiary of the growth in data centers. Its 5%+ dividend yield is attractive to some and with AFFO of 85 cents per share, the 61.85 cents per share dividend appears well-covered at first glance.

Our Concerns:

Many integral cash costs are ignored by the company's REIT metrics and are set to rise when the impact of COVID wanes. If these costs are subtracted from AFFO, IRM is not covering the dividend.

- IRM's AFFO of 69 cps beat forecasts by 5 cps. However:
- Stock compensation more than doubled resulting in the company adding back 7.7 cps to FFO.
- Increased use of finance leases added 3.9 cps as the principal payment portion is added back to FFO.
- IRM's costs benefitted during COVID as key cash costs such as buying out existing contracts for new customers, picking up new customers' files, and other incentives and payments fell. Many of these costs are capitalized and the amortization added back to the company's adjusted REIT metrics. We estimate 12 cps of such costs were added back in the 6/21 quarter.
- Now, these cash costs will rise again. Note that net debt rose $179 million YTD and operating lease liabilities are up as well despite the company selling fixed assets for $214 million of sales leaseback assets against initial guidance of $125 million for all of 2021.

- Project Summit has reached 95% of its intended workforce reduction charges. Workforce reduction was one of the largest expected sources of cost savings yet only 24% of total spending has been towards reducing headcount with the bulk on professional and other fees. We question what outside consultants could know more about this business than the company's management making us wonder if some ongoing expenses made it into some of these one-time charges.

- Storage volume rose by 4.5 million cubic feet but the company acquired 5 million implying negative organic growth.

- Debt is 5.6x EBITDA but jumps to 6.1x when counting cash costs. This is made more alarming by the lack of organic growth.

Keurig Dr Pepper Incorporated (KDP)- Top Sell

Date Added	12/4/2021
Market Cap	$49.7 B
Target Price	$19
PE (fwd)	22
Short %	2.8%
Current EQ Rating	2- (Weak)

How the Bulls See It:

KDP is deleveraging, its sells at a discount to other major soft drink/beverage companies, and its Keurig business gives it exposure to the growing at-home coffee market.

Our Concerns:

- KDP touts its debt reduction efforts, but a closer look reveals the company is simply moving debt to unorthodox short-term financing instruments. One example is the company's accounts payable factoring program which has resulted in payables days climbing to 265 with $2.9 billion being factored receivables. The structured payables account is back to $144 million. Headline debt/adjusted EBITDA jumps from 3.4 to 4.2 by just including these payables.

- Sale leasebacks are adding to future cash costs that will hurt EBITDA going forward, but the proceeds were used to reduce debt.

- KDP cut marketing by $200mm in 2020. In 2021, it has only reported marketing is higher in its two smallest units (17% of sales) – reduced marketing is likely still adding between 2.0-2.5 cents in quarterly EPS.

- Coffee sales received a boost from higher equipment sales during the pandemic.

- Mondelez continues to dump its KDP shares, selling another 28 million in its June secondary offering which represented about 2% of total outstanding KDP shares. MDLZ still owns over 6% of the company and it continues to reduce this.

Mondelez International, Inc. (MDLZ)- Top Sell

Date Added	12/4/2021
Market Cap	$84.4 B
Target Price	$42
PE (fwd)	20.7
Short %	1.0%
Current EQ Rating	2- (Weak)

How the Bulls See It:

MDLZ is viewed as a high-quality packaged food company whose international presence and strong brands give it a superior growth profile compared to many of its peers.

Our Concerns:

MDLZ is constantly in restructuring mode which casts doubt on the quality of the company's non-GAAP earnings. Like most packaged food companies, it has difficulty raising prices more than costs without volume suffering. It also regularly benefits from what we view as unsustainable price increases in Latin America. The 6/21 quarter was no exception.

MDLZ reported EPS of 66 cps which beat forecasts by a penny. However:

- The tax rate was 22.4% versus guidance of "low-mid 20%" which could have accounted for the whole beat.

- Restructuring costs rose to $132 million from $76 million last year. Charges are added back to non-GAAP results and the increase in the quarter added an extra 3 cps. This is the eighth year of this restructuring plan- what is left to streamline, and did any of these charges include management time, travel, and other employee wages that should be viewed as operational?

- Accelerated depreciation and write-offs resulted in another 2 cps in add-backs.

- Organic growth was 6.2% in the 6/21 quarter but this falls to 3.6% without Latin America despite Latin America comprising only 11% of total sales. The disproportionate contribution was driven by easy comps leading to 18.8% volume growth along with a 14.9% increase in pricing while FX was only a 2.8% drain. We see no way for this level of net pricing boost to be repeated.

- Price hikes added $130 million to profits in the 6/21 quarter while cost inflation was only $20 million. Customers will likely notice this, making future price hikes more difficult without crushing volumes. Like most, MDLZ is also forecasting higher costs which will pressure margins.

- Biscuit demand has been declining since the 6/20 quarter and accounts for 50% of total sales.

Patterson Companies Incorporated (PDCO)- Top Sell

Date Added	3/12/2021
Market Cap	$3.1 B
Target Price	$23
PE (fwd)	15.5
Short %	7.6%
Current EQ Rating	2- (Weak)

We moved PDCO from a Top Sell to an On Deck Sell on 6/25/2021 after a disappointing April 2021 quarter led to a 10% price decline. We returned PDCO to the Top Sell on 9/3/2021 following 6/21 results.

How the Bulls See It:

PDCO is a leading distributor of products for dental practices which will benefit from the aging demographic.

Our Concerns:

- PDCO continues to benefit from one-time gains. Non-GAAP EPS beat targets by 6 cps in the 7/21 quarter but the company raised its mid-point for 2022 guidance by just 2.5 cps. Non-GAAP results benefitted from lower tax rate (2.3 cps), a smaller loss on the securitization of receivables plus a gain vs. a loss on the sale of finance contracts (1.6 cps), lower stock compensation (1.4 cps), an extra week (2.8 cps), and results were rounded up by 0.2 cps.

- Personal Protective Equipment (PPE) sales have weakened further. Incremental YOY growth in PPE appears to have fallen to around $1 million in the 7/21 quarter. Despite the company assuring investors five weeks before the quarter that the PPE market was stabilizing, it took another $49 million in charges to write down PPE inventory donated to charity.

- We estimate the company has earned an incremental $4-5 million in profits from PPE equipment during Covid, but it has taken $60 million in charges to write off inventory and it expects investors to ignore these charges which it adds back to non-GAAP results.

- The Animal division has received a huge boost from people getting new pets during the pandemic. Comps get more difficult moving forward and we could see internal growth turning negative by the end of the fiscal year.

- Inflation appears to be pushing down gross margin despite the company's claim it is not significant. Adjusted gross margin was down to 20.2% in 1Q22. That is important because it was 21.0% in 4Q21 – after adding back the LIFO charge and the write-down of PPE inventory like PDCO advised. We noted last quarter that the inventory charges could have pulled future COGS into 4Q and help drive gross margin in 1Q. PDCO also had an extra week which could have leveraged some costs further.

- Cash flow looks weak despite a surge in DPP collections of previously sold receivables. PDCO adds the DPP collections into free cash flow and the figure is still negative at -$6 million for 1Q's FCF before acquisitions. That is with inventories still very low at 57 days vs. 70 and receivables are down to 48 days vs. 55 days. We could certainly see both accounts needing to increase further and be a headwind for cash flow. Plus, DPP collections likely will normalize at lower levels and further hurt cash flow.

Sealed Air Corporation (SEE)- Top Sell

Date Added	12/4/2021
Market Cap	$8.7 B
Target Price	$32
PE (fwd)	16.5
Short %	1.3%
Current EQ Rating	2+ (Weak)

How the Bulls See It:

SEE is seen as a defensive stock with a potential for growth propelled by growing e-commerce traffic.

Our Concerns:

- SEE was taking prices above inflation for years before 2021 despite its deals with customers calling for the price/cost balance to net to zero over time. This is now reversing against the company as the 6/21 quarter saw a $36 million price/cost headwind following an $18 million headwind in the 3/21 quarter. From the earnings call, almost everything at SEE for the rest of this year and into 2022 revolves on 1) being able to take pricing and 2) have commodity inflation weaken and let SEE keep the excess pricing they lost the first half of 2021. The increased revenue guidance given after 2Q21 was repeatedly attributed almost solely to higher pricing the company expects to achieve. We have noted that price/cost differentials for commodity prices have worked in SEE's favor in almost every quarter for over three years. These are supposed to net to zero over time. That does not bode well for SEE simply getting all the pricing it needs to recover the last two quarters.

- This outlook is not helped by the fact that LYB is forecasting much higher plastic prices due to very low customer inventories and LYB having to fill orders "hand to mouth."

- We believe SEE's price increases will occur but may prove inadequate to handle the increase in commodity costs. It is also important to note that while SEE expects a negative headwind from price/cost spread in 3Q, it will only have 15 days of higher prices in place for 3Q. That could be an area where they miss guidance for 3Q and if the price hikes do not cover the commodity inflation that could be in place going into 4Q, SEE may need to reduce forecasts.

- The current quarter could show one of two outcomes. SEE may pull sales forward from the rest of 2021 as customers try to stock up on supplies before the price increase takes effect. That would likely help SEE hit sales forecasts for the quarter, but it will have locked in lower margins and hurt future sales growth and guidance may reflect that change. Or, SEE will get its price increase to work as expected starting September 15 and it only gets a price increase impact for 15 days of the quarter and cost increases have been occurring throughout the period. This means fifteen days of higher sales prices against 92 days of higher costs.

- SEE’s organic growth figures have been benefitting by enjoying higher prices in Latin America while adjusting out the associated FX effects. In the 6/21 quarter, the company apparently took pricing gains again but the FX hit turned positive.

- The Reinvent SEE restructuring program started in 2017 but the company still added back 2.1 cps paid to third-party consultants in the 6/21 quarter. We are curious as to what advice third-party consultants are still giving at this point.

- The protective business has been growing with the company picking up 2-4 cps so far this year from vaccine rollouts. However, the easy comps here are now up.

Sysco Corporation (SYY)- Top Sell

Date Added	6/11/2021
Market Cap	$38.8 B
Target Price	$65
PE (fwd)	21.7
Short %	1.8%
Current EQ Rating	3- (Minor Concern)

How the Bulls See It:

SYY is expected to enjoy strong growth from the post-COVID return to dining out. It is the largest restaurant supplier in the country and it added to its industry-leading market share during the pandemic due to its ability to offer value-added services to its customers.

Our Concerns:

- During the first two quarters of the pandemic, SYY took unusually large provisions for bad debt to build up allowances on receivables generated before the onset of the pandemic as a result of the stress of lockdowns on its customers. SYY added these amounts back to its non-GAAP results in the 3/20 and 6/20 quarters. As conditions improved and visibility into the ability of its customers to pay these receivables increased, the company began to reverse some of these reserves leading to net credits for bad debt expense in the last several quarters. SYY removed these credits related to pre-pandemic receivables from its non-GAAP results. However, as we pointed out in our review of the 3/21 quarter, the company did not remove $10 million of credits related to receivables generated ***after*** the onset of the pandemic. In the 6/21 quarter, provision for bad debt after adjustments for changes in pre-pandemic allowances fell to 0.05% of sales from 0.23% in the year-ago period which we estimate added over 4.5 cps to earnings in the period.

- The allowance for bad debts as a percentage of gross receivables fell to 3 percent at the end of the 6/21 quarter from over 10% a year ago. This is still above the pre-pandemic range of around 1%, so the company could still see some benefit from adjustments to existing reserves. However, we believe the 4-5 cps tailwind experienced in the last two quarters from bringing down bad debt reserves will fade going forward.

- SYY's non-GAAP tax rate fell to 20.2% from 22.8% in the year-ago period adding 2.3 cps to earnings growth in the period. The company guided towards a 24% effective rate for

the full year at the beginning of fiscal 2021 so we believe the 20.2% rate was below what most analysts' models were expecting.

- SYY was extremely upbeat on the 6/21 quarter call, stating that it had not seen a negative impact from the Delta variant as of the end of the June quarter. However, we note that competitor US Foods Holdings was a little more cautious on its call stating: "Most of July was also in line with May and June, but we did see in the last two weeks, a tick down of about 100 basis points. But it's too early to say whether that small change is due to the impact of the Delta variant." The possibility of disappointing dining traffic, especially if there is a surge in Delta cases in the North as the weather cools remains a significant overhang for the stock.

- SYY experienced product cost inflation of 9.6% in the quarter centered in categories like poultry, beef, paper, and consumables. Most of the company's contracts contain pass-through provisions so while gross margin may be pressured, absolute gross profit dollar growth could be relatively unscathed. However, we are more concerned about the negative impact of potential sourcing problems as the supply chain remains under considerable stress.

TransDigm Group Incorporated (TDG)- Top Sell

Date Added	3/12/2021
Market Cap	$33.8 B
Target Price	$480
PE (fwd)	53.1
Short %	3.7%
Current EQ Rating	2+ (Weak)

How the Bulls See It:

TDG is a leading supplier of aircraft components and has driven growth by acquiring makers of unique replacement parts and increasing prices on customers who have nowhere else to source. The company will drive growth as air travel returns post-pandemic.

Our Concerns:

- TDG's growth through acquisition strategy has left it a huge debt load. Headline debt to adjusted EBITDA is 7.6x and using a pre-Covid EBITDA, it is still 6.5x.
- The debt problem is further magnified by the tax shield disappearing under section 163(j). Previously, the amount of interest TDG could shield against taxes was 30% of EBITDA and now that is 30% of EBIT. Under the CARES act, during the pandemic companies were given a two-year reprieve where they could shield 50%. This already drove the 3/21 quarter effective tax rate to 19.6% from 4.2% y/y largely as a result of section 163(j). We estimate this will be about 20-30-cents in EPS per quarter this year. This effectively reduces ROI and the amount of debt TDG can carry.
- Recent growth is coming more from defense contracts and less from travel returning.
- We see a risk of impairment from contracts related to older aircraft where the original assumptions call for these planes to be in service for 30 years, yet accelerated airline fleet upgrades may significantly reduce these useful lives.
- We believe the quality of earnings is eroded by the company's practice of adding back the amortization of contract loss reserves.
- Possible boosts to the upcoming 9/21 quarter include FIFO accounting deferring the impact of rising costs and the buildup in inventory reserves reversing.

“On Deck” Sells

These are companies under coverage with material problems but are not currently on the Top Sell list due to valuation or timing factors.

Ball Corporation (BLL)- On Deck Sell

- BLL has been aggressively stretching working capital to generate cash to cover its capital spending program. Factored but outstanding receivables days of sales jumped to 39 in the 6/20 quarter from 35 in the year ago quarter. Total receivables days adjusted for factoring rose to 94 from 82. The limit on the factoring facility has been raised to $1.8 billion from $1.2 billion in 2019 and the size of factored but outstanding receivables now exceeds receivables left on the balance sheet. The increase in factored receivables added about $200 million to cash flow growth in the first six months of the year.

- Despite a 7.5-day YOY drop in inventory DSIs, days payable outstanding rose to 130.6 from 110.1. The ratio of payables to inventory returning to normal over the next few quarters will prove to be a drain on cash flow growth. For reference, the trailing 12-month period ended 6/21 saw a $1.26 billion increase in payables versus a $102 million increase in inventory providing a $1.16 billion tailwind to cash flow growth in the period.

- Without the accelerated receipt of cash from expanding payables and factored receivables, BLL would not have come close to covering the current buyback and dividend in the trailing 12 months ended 6/21. If we count the increase in payables and factoring as debt, the leverage ratio jumps to 4.4. We understand that if the company can get all the new production up and running and sell the cans at expected prices then cash from operations will expand, capex will come down, startup costs will subside, and there will be plenty of cash to reduce debt and return to shareholders. However, the short-run seems to depend very much on unorthodox short-term financing which does not show up in some investors’ debt metrics. It does not seem to us that this risk factor has enjoyed much public discussion.

Conagra Brands, Inc. (CAG)- On Deck Sell

We bumped CAG down to On Deck Sell from Top Sell on 7/14/2021 following the price drop after 6/21 earnings. However, we still have significant concerns:

- Covid allowed CAG to clear the shelves of its older products without markdowns or promotions. Moving forward, CAG will need to live in the real world again where Mondelez, Del Monte, Pillsbury, Swanson's, Weight Watcher's, and numerous store brands want the shelf space too and grocers aren't out of inventory.

- Lower promotional spending has been a large part of profit improvement during Covid. Promotional spending is netted against sales. We know in 2Q and 3Q – half the pricing gains were due solely to lower y/y promotional spending and CAG said that helped 4Q too. They now have very tough comps in that area. CAG is guiding that it will continue to pay less on promotional spending forever and thus there won't be a headwind on pricing from a return of normal promotional activity. History indicates this is an unrealistic expectation.

- CAG is still not replacing the lower promotional spending with higher traditional advertising either. 4Q21 advertising came in at $75.2 million, basically equal to 4Q19 (without Covid) and 3Q21. We have pointed out many times, that CAG was spending more on advertising in the time before it added Pinnacle Foods to the mix as a much smaller company. It's going to be difficult to claim premium prices and convince grocers to take your product and replace existing products with your new offerings as you spend less promoting and advertising.

- CAG continually takes impairments on its brands. Could there have been a stronger period for sales than in fiscal 2021? Yet, CAG took a $95.5 million brand impairment. During fiscal 2020, the impairment was $260 million, 2019 - $94 million, 2018 - $15 million, 2017 - $343 million.

- CAG is another company in serial restructuring mode which greatly reduces the quality of reported earnings.

Eaton Corp. (ETN)- On Deck Sell

ETN has been beating forecasts in the last few quarters. It has been a huge beneficiary of conditions normalizing after Covid and a high backlog should help propel strong sales growth for the rest of 2021. However, ETN has received some temporary non-operational benefits that will disappear and lead to more difficult comps next year. This prompted us to move ETN to the On Deck Sell list.

- ETN began adding back amortization of intangibles to non-GAAP results. While this was a known event, it nonetheless added 18 cps and 25 cps to the 3/21 and 6/21 quarterly results, respectively. This is increasing the spread between GAAP and Non-GAAP results and boosting earnings at a time the stock is already trading for high multiples of 22x adjusted EPS.

- Freezing US pension plans at the start of the year and paying out some lump-sum distributions reduced service cost and some amortization y/y in 1Q and 2Q. This added 8-cents to EPS in both periods and should be a tailwind for the rest of 2021. We don't regard this as a true improvement in operating results.

- We estimate that ETN picked up 85bp of operating margin in 2Q21 simply from Covid pent-up demand being met and leveraging costs like depreciation and R&D. That's nearly 8-cents in EPS last quarter. Going forward, R&D is increasing again and the sales comps are not nearly as easy as 2Q.

- Divesting the lighting business and the hydraulics unit helped margins too. Both of these had EBITDA margins of about 11% and subtracting them gave the remaining ETN business an increase in margin of 190bp. Those units were classified as discontinued for most of 2020. We think Covid's lower sales masked some of this benefit that is being seen in 2021. This is not an item that should improve further.

- Recent acquisitions came with much higher margins. So far Tripp Lite with an EBITDA margin of 34% has only been in place since mid-March and Cobham's 29% margin since June 1. Simply adding these to the mix should boost margins by 50bp. There are 3 more quarters of apples-to-oranges comps to come. However, we again do not see this as a source of never-ending margin gains.

- Debt is up to 3.6x EBITDA following the acquisitions compared to years of the multiple being about 1.5x. Payables are also being stretched at this point too – rising from 50 days to 64.

Henry Schein, Inc. (HSIC)

We are removing HSIC from our On Deck Sell list.

- The company was receiving a large tailwind from the sale of PPE (personal protection equipment) and other Covid-related products including test kits. Test kit revenue fell sequentially to $75 million in the 6/21 quarter from $180 million in the 3/21 quarter. Still, we estimate that growth in PPE revenue could have contributed over 5% of total sales growth, but this is down from over 20% in the 3/21 quarter.

- Gross margin benefitted from lower markdowns to PPE inventories versus a year ago. The company does not quantify the markdowns and the lack of visibility is a concern, but we find this preferable to PDCO's adding back PPE markdowns to non-GAAP results.

- HSIC recorded a credit of $1.4 million for bad debt provision in the 6/21 quarter versus an expense of $14.2 million a year ago- adding 9 cps to earnings growth. However, almost balancing this out was a 7 cps increase in stock option expense.

Kimberly-Clark Corporation (KMB)- On Deck Sell

We are adding KMB to our On Deck Sell list.

KMB missed 6/21 estimates of $1.47 per share by 24 cps due to much higher than forecast raw materials inflation and weaker than expected Consumer Tissue sales. However:

- KMB increased its cost savings targets for 2021 by $110 million after the second quarter and identified $145 million in savings in the second quarter alone from FORCE program savings and its 2018 Restructuring Plan. The company continually claims to realize hundreds of millions of dollars in cost savings every year in addition to savings from ongoing named restructuring programs. We view the recent accelerated cost cuts as merely deferrals which will eventually have to be incurred at the expense of future growth.

- KMB is a serial restructurer that regularly adds back hundreds of millions of dollars of charges to non-GAAP earnings every year.

- One-time benefits in the 6/21 quarter include lower stock compensation (4.5 cps), lower adjusted non-operating expenses (1.6 cps), and higher adjusted other income (0.7 cps).

- KMB received a $100 million tailwind in the 12/20 quarter from favorable rebate accrual settlements which will make for difficult comparisons in the fourth quarter.

Mohawk Industries, Inc. (MHK)- On Deck Sell

We are adding MHK to our On Deck Sell list.

MHK is posting strong results from the push by homeowners to upgrade driven partly by booming housing and partly by the pandemic. The 6/21 quarter results were strong, beating top-line estimates by over $200 million and topping EPS targets by 76 cps. However, we noted several one-time benefits to results that make the bottom-line outperformance less impressive than it appears on the surface.

- Accruals for product warranties declined sequentially despite an almost $300 million sequential increase in sales. This compares to the year-ago quarter where accruals rose sequentially on a decline in revenue. This drove warranty accruals on a days of sales basis down to 1.7 days from 2.4 days a year ago. We estimate this could have added over 25 cps to earnings growth in the period.

- The allowance for doubtful accounts fell to 4.2% of gross receivables compared to 4.8% a year ago and 4.8% in the 3/21 quarter. We estimate this could have added over 12 cps to earnings in the period

- MHK's Other Expense (Income) line jumped to an income of $11.2 million in the 6/21 quarter from a $1.4 million expense in the year-ago quarter. The company stated in the 10-Q that this was "primarily attributable to the resolution of foreign non-income tax contingencies of $6.2 million and other miscellaneous items." The $6.2 million benefit was adjusted out of non-GAAP results. However, the "all other" category jumped to $6.1 million in income from virtually nothing last year, adding almost 7 cps to earnings in the quarter.

- Amortization of capitalized contract costs fell, adding about 5 cps to earnings growth in the quarter. The company has been capitalizing a smaller amount of contract-related costs which we suspect is due to fewer in-store display placements in the current environment. We expect these costs will increase as conditions return to normal.

- MHK remains the subject of shareholder lawsuits and SEC and DOJ investigations into claims it fabricated revenue by attempting to deliver product to customers that were closed and then recognizing the sales, overproduced product to boost reported margins, and improperly valued inventories it knew were defective. As we discussed in past reviews, our analysis of receivable and inventory trends does not indicate wrongdoing as

large as what is implied in the allegations. However, this matter could still result in negative news flow and remains an overhang to the stock.

TreeHouse Foods, Inc. (THS)- On Deck Sell

- THS met EPS forecasts but promptly cut guidance for the year from $2.80-$3.20 to $2.00-$2.50 which is below what it was earning pre-Covid and before extensive restructuring. It cut revenue guidance too and missed in 2Q after posting -7.3% organic growth with only 0.1% in pricing. Higher commodity pricing is hitting THS hard in our view. Meeting EPS forecasts was helped by guiding to a 25%-27% tax rate for 2Q and coming in at 21.2%. The company also added back a larger figure of $39 million for restructuring (it's 4th restructuring in 3-years) and still had $4.5 million in Covid costs it added back. Without these items, THS missed badly and lost money.

- Margins continue to fall as well – this is despite culling low-margin SKUs. Margins were down 420bp in meal prep and 360bp in snacking. The inability to take pricing should be a red flag and it appears supermarket store brands are taking shelf space from THS.

- Debt is 4.0x adjusted EBITDA but the whole company is only 8.6x EBITDA. We see big problems with earnings quality here and we're not sure there is much evidence of value in THS brands. However, at a market cap of only $2.2 billion – this is a company that often gets attention from people who believe it can be LBOed or sold for a higher multiple. Thus, that remains the biggest risk to being short THS.

Top Buys

Air Lease Corp. (AL)- Buy

Date Added	12/4/2021
Market Cap	$4.4 B
Target Price	$65
PE (fwd)	12.8
Short %	3.5%
Current EQ Rating	4+ (Acceptable)

- AL's adjusted EPS of $1.10 beat forecasts by 23-cents. The key reason for the beat was AL sold a receivable for deferred rent that was part of AeroMexico's bankruptcy. That was $34 million and was basically 24-cents of EPS. Delays in deliveries may hold back 3Q21 results but we believe AL can return to EPS well in excess of $5, making the P/E ratio under 8x. We see additional growth as airlines lease a higher percentage of their fleets and offsets delivery delays from Boeing and Airbus.

- AL's newer planes remain highly desirable and the usage rate by its airline customers for AL planes is 99.7%.

- The number of customers asking for rent relief is declining. In the 6/21 quarter, $42 million of rent had revenue recognition deferred until cash is received. That is down from $49 million in the 3/21 quarter. Also, of the $242 million of deferrals made since Covid, only $115 million has yet to be repaid at this point. That is down from $131 million in early May. Collecting the rest and having smaller new deferrals should boost revenues and cash flow as well as margins since the depreciation and interest expense incurred when the rent was deferred have already been recognized.

- In the 6/21 quarter, AL also entered into $45 million of lease restructurings. Thus, it did not recognize $87 million in rental revenue for the quarter ($45 million here and the $42 million that was deferred). Overall, the situation appears to be improving in that deferrals and restructurings are likely closer to being completed than started. AL expects to collect deferred rent by the end of 2022. That will help margins and cash flow recover going forward. For us, the bigger headwind remains delays from Boeing and Airbus. AL has a balance sheet that can put almost twice as many planes in the portfolio every year than it is currently receiving.

- AL's operating model is to buy new planes and sell planes as they reach essentially 6-8 years of age. Trading aircraft – both its own planes and those for other portfolios – has often been a reasonable part of EPS. However, with Covid, trading largely disappeared. Recent gains reported in this area have focused on items like selling the AeroMexico claim or refinancing debt. AL is planning to counter the delays in deliveries of new planes by delaying aircraft sales for the rest of 2021 and perhaps into early 2022. This could make this source of revenue and earnings depressed for 2-4 more quarters.

- The accounting is conservative and the company has significant liquidity. At some point, AL will either need to find ways to expand the number of planes it has with more sale-leasebacks with customers or it can retire debt and shares and grow EPS with the current fleet. We think either way – there should be more potential for improvement in the results.

AT&T Inc. (T)- Top Buy

Date Added	3/12/2021
Market Cap	$195.1 B
Target Price	$40
PE (fwd)	8.5
Short %	1.5%
Current EQ Rating	4+ (Acceptable)

Longer-term, while investors are giving up 88 cps in annual dividends, they are getting:

- 71% of NewCo which we value as high as $10 per share. Forward EBITDA is forecast at $14 billion when the spin-off occurs in mid-2022 with $60b in debt. Warner assets have sold for over 12x, at 10x – 71% of the spin-off is worth $7.90 per share to AT&T shareholders.

- Faster growth at NewCo (vs AT&T) should drive further capital appreciation. That company will also look to reduce debt. Without changing the EBITDA multiple or earnings – every $1 billion in debt reduction should boost the stock value owned by AT&T shareholders by 10-cents. The target is to reduce NewCo's debt by $15-$18 billion within 24-months.

- Debt at T should decline from $168 billion to under $100 billion at the time of the spin-off with $43 billion being sent to NewCo, asset sales that already occurred and free cash flow after the divided being devoted to debt reduction. That should save AT&T $3 billion in interest expense. Lower interest expense and higher free cash flow after the dividend should allow continued debt reduction at AT&T too. Debt to EBITDA is currently 3.15x and should be 2.6x after the spin-off falling below 2.5x by the end of 2022.

- The benefit of maintaining HBO Max bundling deal.

- More investment in T's core business to drive future growth – Broadband is expected to double in size within 5-years.

We continue to value the sum of the parts at least $40. The simplest way to look at it is AT&T's wireless unit is growing even without roaming fees from international travel. VZ trades for 8x EBITDA, AT&T's wireless at 8x less the entire company's remaining $100 billion in debt would be worth more than $20 by itself. The spin-off is worth between $7-$10 and the whole company is valued at $27 in the market today. Investors get the growing broadband (CAGR of 14%) and the cash flows of business phones and several other parts for free with no debt associated with them as we already deducted all the debt from wireless. In addition to growth, there are plans to create shareholder gains via deleveraging both AT&T and NewCo.

LyondellBasell Industries N.V. (LYB)- Top Buy

Date Added	7/14/2021
Market Cap	$31.4 B
Target Price	$140
PE (fwd)	4.9
Short %	1.6%
Current EQ Rating	5+ (Strong)

Added to Top Buy list on 7/14/2021.

- Demand is high and plastics are in short supply leading to higher prices and rising EBITDA. Industry maintenance and building delays will keep supplies down and prices high.

- Cash flow is strong and the company is retiring debt. Net debt is $12.7 billion and the company has plans to push it below $12 billion. The debt rating was upgraded by S&P and leverage is 2.05x trailing EBITDA. We expect it will be under the 1.5-2.0x target by the end of the year.

- The Advanced Polymer Solutions segment is posting flat results due to the semiconductor shortage hurting car and appliance production. However, this problem should start reversing in the fourth quarter and result in strong demand in 2022.

- With new production already online – LYB's base EBITDA is $8 billion which can move up on stronger pricing and additional capacity coming within 2 years. We see LYB as being very cheap at these levels. If the stock rose 40% it would still be trading for only 7x base EBITDA that is already producing.

- R&D and SG&A are up- we see earnings quality as very strong.

Mowi ASA (MHGVY)- Top Buy

Date	12/4/2021
Market Cap	$14 B
Target Price	$29
PE (fwd)	23.9
Short %	-
Current EQ Rating	4+ (Acceptable)

We continue to see a significant upside in Mowi from a rising dividend. The company increased the dividend to 0.96 NOK in the 6/21 quarter, up from 0.77 NOK in the previous quarter. Investors should remember the company was paying 2.6 NOK before the pandemic. Debt is down from €1.48 billion in 4Q to €1.15 billion after 2Q21. The company has a policy of paying out 50% of income as a dividend and there are several reasons to believe earnings growth will continue off the pandemic low:

- Pricing gains should continue as prices on Norwegian salmon are still not fully recovered. More important is the supply/demand situation. In the 2Q, demand grew 9.3% with new harvested supply only rising 1.1%. The market filled in with supply from frozen inventories which made the total supply on the market rise 9%. Frozen supplies from Chile had been contributing to weaker pricing in recent quarters and those are now declining.

- MOWI's supply growth was expected to be 1.2% in 2021. The forecast has now been raised to 2.3%. However, the industry expects negative growth for the rest of the year on salmon volumes. For 3Q it is expected to be in a range of -7% to -2% and for 4Q, a range of -4% to 0%. Most importantly, the swing producer is Chile. After overproducing in 2020, Chile is expected to post negative volume growth in 3Q of -31% to -27% and -25% to -22% for 4Q.

- Demand growth still has room to recover. China had been a growing market that remains about 20% below pre-Covid levels. Also, the rollout of more salmon products in the US was delayed with Covid. Demand has picked up significantly since Covid restrictions eased, but the focus is still on tripling US demand over 10-years. MOWI also notes that freight costs remain higher than pre-Covid too. That is something that should continue to gradually improve with more air travel and help get more supply to more markets.

- Guidance for cash flow consumption remains flat for MOWI: €110 million tied up in higher working capital, taxes of €60 million, interest of €45 million, and capital spending of €265 million with over 40% focused on growth projects.

National Instruments Corporation (NATI)- Top Buy

Date Added	3/12/2021
Market Cap	$5.6 B
Target Price	$50
PE (fwd)	26.4
Short %	2.3%
Current EQ Rating	5+ (Strong)

- Order demand continues to push up backlog. Backlog is ordinarily one week of sales but it finished the 6/21 quarter at four weeks. Backlog is expected to end the year at three to five weeks of sales. Management is clear that it does not have a history of customers double or triple ordering. It is reasonable to expect the bulk of this backlog to convert to sales resulting in a huge boost to revenue in the first half of next year as it returns to one week.

- The backlog buildup has been a drain on reported margins due to deleveraging. If $50 million of backlog had converted to revenue in the quarter, R&D would have been a 2.3 cps tailwind instead of a 3.7 cps headwind. G&A costs would have been a 3.7 cps tailwind instead of just a 1.5 cps tailwind.

- Goals of 20% operating margin appear reasonable as higher-margin software revenue is expected to grow.

- It appears the company's restructuring program will end on schedule and non-GAAP add-backs have been minimal. Overall earnings quality appears strong.

Texas Instruments Incorporated (TXN)- Top Buy

Date Added	3/12/2021
Market Cap	$180.1 B
Target Price	$216
PE (fwd)	24.7
Short %	1.5%
Current EQ Rating	5+ (Strong)

- TXN is still having a tough time rebuilding inventories. DSI's were only 113 days after 2Q21 down from 125 in 4Q and a normal level above 140 days. It's worth noting that finished goods are only half of last year at 40 days vs. 77. That has helped cash flow of late but could pressure sales growth. Because TXN holds more inventory than many competitors – it may be gaining more future business as a result of all the Covid disruptions.

- We remain impressed with TXN's earnings quality overall. It didn't cut R&D and overhead during Covid so now the higher sales leverage into higher margins and earnings.

- TXN continues to boost its dividend that remains well within its ability to fund it.

UnitedHealth Group Incorporated (UNH)- Top Buy

Date	6/11/2021
Market Cap	$389 B
Target Price	$480
PE (fwd)	22.3
Short %	0.7%
Current EQ Rating	5+ (Strong)

- UNH is now past the difficult comps from Covid when they were collecting premiums but people were not visiting the doctors' offices and inflated the medical ratio and operating income. Even as business normalizes, UNH is handily beating forecasts.

- During Covid, UNH was posting higher revenues from premiums and also rebates that it earns. Yet, it could not bill for the rebates at the time because patient visits were low. That is normalizing too and allowing UNH to see more cash flow rather than building accruals.

- The company routinely covers acquisitions, dividends, and share repurchases from free cash flow. Our biggest concern is the repurchases are producing almost no impact on EPS growth and we wonder if UNH could find better avenues for growth with that cash.

- Forecasts of $18.30-$18.80 for 2021 already have $1.80 in Covid costs baked in. That could help preserve UNH's history of beating forecasts.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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